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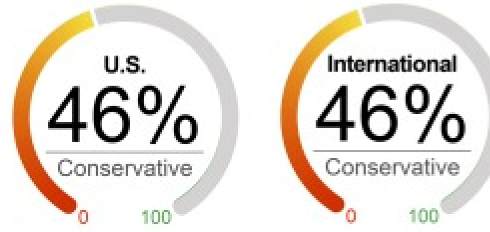
March 2023

The Navigator

Current Equity Exposure



All three major U.S. equity indexes ended lower in February as investors weighed some resilient economic data against fears that inflation might not decelerate quickly, and the Fed would likely raise the fed funds rate higher than expected. We maintain our view that the equity risk/reward outlook is skewed to the downside, with persistent inflation, monetary policy uncertainty, mounting margin pressures, and potential geopolitical risks. We remain underweight in equities but are utilizing the current downturn as an opportunity to slightly increase our U.S. equity exposure from 40% to 46%. We increased our international equity exposure from 37% to 46%, reflecting better valuations, improved growth outlooks, and tailwinds from China reopening.

The Factors

Valuation

- Valuation metrics for equity remained negative. P/E decreased slightly from 19.3 at the end of January to 19.1 at the end of February.
- Forward P/E fell to 18.1 at the end of February from 19.3 at the end of January.
- Inflation-adjusted valuation metrics continued to be negative.
- Equity valuation metrics relative to bonds remain negative with high bond yields.

Sentiment

- U.S. manufacturing activity continues to contract, with the ISM manufacturing index falling to 47.4 in January.
- University of Michigan consumer confidence inched higher in February to 67.0, supported by continued job growth and recent lower gasoline prices.
- The NAHB index increased by 7 points in February, helped by the moderate increase in demand.

Technical

- Technical indicators were neutral, with the decline of momentum signals offset by short-term reversal and fear indexes.
- The S&P 500 was 1% above its 200-day moving average, 1% above the 100-day average, and 0.2% below the 50-day average.
- The VIX index increased this month and settled at 20.6, with worries of sticky inflation and fears that the Fed will keep interest rates higher for longer.

Macroeconomic

- Nonfarm payrolls rose by 517,000 in January, far exceeding expectations. The four-week moving average of initial jobless claims fell to 192,000 as of February 18.
- Retail sales soared in January by 3%, led by vehicle sales. We expect modest growth of retail sales, supported by the tight labor market.
- U.S. industrial production was unchanged in January.

What's Driving the Markets?

International Equity Markets: We believe that international equity markets, including the eurozone, Japan, and emerging markets could offer opportunities for better risk-adjusted rewards. Given the fast decline in energy prices, higher confidence indices, and better-than-expected real GDP growth, we now see an improved growth outlook for the eurozone area. We also anticipate a relatively positive environment for emerging markets equities as China reopens and emerging market central banks are ahead of developed market peers in policy tightening. Furthermore, the slowing pace and a later pause of the Fed's rate hikes would likely spur a further depreciation of the US dollar, thus helping international assets. International equity valuations remain more attractive, with the US trading at a P/E of 19, compared to the Eurozone and Japan at around 13 and emerging markets at 11.

Persistent inflation: January inflation readings surprised to the upside and suggested inflation is not declining as smoothly as some investors had anticipated. The consumer price index and producers price index rose 0.5% and 0.7% in January, respectively, both higher than expected. Our view remains that inflation will moderate further this year but will likely settle closer to 3% (versus the Fed's 2% target). One silver lining is that rental inflation (outsize weight in the CPI) will likely decelerate in mid-2023, given that rent growth shows up in the CPI calculation with a lag.

The Fed Funds Rate – Higher for Longer: The Federal Open Market Committee announced a 25-basis point increase to the target range of the federal funds rate, bringing the target range to 4.5% to 4.75%. The minutes of the February FOMC meeting noted that all participants continued to anticipate that "ongoing" rate increases would be appropriate going forward. The Fed's messaging has skewed more hawkish during the month, sending signals that the fight against inflation could require more tightening. In our view, the stubbornly high inflation, and recent resilient economic data pose upside risks to the terminal rate.

Corporate Earnings: As of 02/24/2023, among the 94% of S&P 500 companies that have reported Q4 2022 earnings, 68% of them have reported a positive EPS surprise, and 66% have reported a positive revenue surprise. However, the blended earnings decline for the S&P 500 is -4.8%. The breadth of companies struggling with margin pressures is high, with slowing sales, elevated input costs, and high wages.

As of 2/28/23. Data provided by Bloomberg, NorthCoast Asset Management, Federal Reserve History.

[1] The NorthCoast Navigator is a market barometer displaying NorthCoast's current U.S. and international equity exposure and outlook. This aggregate metric is determined by multiple data points across four broad market-moving dimensions: Technical, Sentiment, Macroeconomic, and Valuation. The daily result determines equity exposure in our tactical strategies.

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